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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1146

THE COASTAL CLUB, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Petitioner respectfully submits this reply to the Memorandum For The Respondent In Opposition, filed on April 13, 1967. The purpose of such reply is first to point out that petitioner and respondent appear to be in agreement as to the criterion used by the Tax Court and the United States Court of Appeals for the Fifth Circuit in revoking petitioner's exemption as a

social club under Section 501(c)(7) of the 1954 Code; secondly, to challenge the authorities cited by respondent in support of such criterion; and, finally, to answer respondent's contention that the decisions below do not present a conflict with other authoritative interpretations of such statutory exemption which should be resolved by the Supreme Court.

(1) At the top of page 4 of his Memorandum In Opposition, respondent makes plain his agreement with petitioner's contention that the Tax Court and the United States Court of Appeals for the Fifth Circuit below used as their criterion for revoking petitioner's exemption as a social club a new test, namely whether a "profit-making purpose" exists with respect to petitioner's passive receipt of outside income (but apparently only where such profits exceed some undefined amount described only as "substantial"), rather than the test which had theretofore been applied by the courts, to wit, whether a social club's outside income is derived from engaging in business.

At pages 2 and 3 of his Memorandum In Opposition respondent states that petitioner's outside income inured to the benefit of its member-shareholders by virtue of the fact that such income, while never actually distributed, was used to meet petitioner's expenditures for club purposes. Petitioner points out that where a social club has not engaged in business and its outside income has been used solely for club purposes, the traditional view of the courts has been that such use does not result in the inurement to the benefit of private shareholders proscribed by Congress. See *Santee Club* v. *White*, 87 F. 2d 5 (1st Cir. 1936); *Koon Kreek Klub* v. *Thomas*, 108 F. 2d 616 (5th Cir. 1939); *Anderson Country Club, Inc.* v. *Commissioner*, 2 T.C. 1238

(1943); *Coeur D'Alene Country Club* v. *Viley,* 64 F. Supp. 540 (N.D. Idaho 1946); and *Clements Buckaroos* v. *Commissioner,* T.C. Memo 1962-18 (1962). It is only in those cases where the outside income is first determined by the court to be derived from the conduct of a business that the use of such income solely for club purposes has been held to inure to the benefit of private shareholders. See *Aviation Club of Utah* v. *Commissioner,* 162 F. 2d 984 (10th Cir. 1947) *which respondent significantly fails to cite; West Side Tennis Club* v. *Commissioner,* 111 F. 2d 6 (2nd Cir. 1940); and *Jockey Club* v. *Helvering,* 76 F. 2d 597 (2nd Cir. 1935).

It is submitted that the authorities cited by respondent at page 4 of his Memorandum In Opposition do not support his position that the existence of a profit-making purpose is the proper test for judging whether a social club's outside income is contaminated. G.C.M. 13067, XIII-2 C.B. 148 (1934), cited by respondent, involved the income-producing activities of an association of clubs. Such activities consisted of "sponsoring, conducting, or managing tournaments, handicapping players, and attending to matters incident to the tournaments", all of which adds up to conducting a business with the general public. See *West Side Tennis Club* v. *Commissioner, supra.* Respondent also relies on I.T. 2622, XI-1 C.B. 65 (1932), holding that a single sale of real property no longer useable for exempt purposes cost the social club its exemption, but this clearly conflicts with the 1937 amendment of the Regulations on social clubs recognizing for the first time, pursuant to *Santee Club* v. *White, supra,* that "an incidental sale of property will not deprive the club of exemption".

Respondent also cited *Jockey Club* v. *Helvering, supra,* in support of his proposition, but there can be no serious doubt that the income-producing activities of the Jockey Club, including the maintenance of a horse-breeding bureau and breeding station, the registration of thoroughbred horses and the publication of a stud book, the supervision of horse races, the issuance of licenses to trainers and jockeys, the maintenance of a disability fund for disabled trainers and jockeys, and the publication of a monthly racing magazine, all added up, as the Fifth Circuit noted in *Scofield* v. *Corpus Christie Golf & Country Club*, 127 F. 2d 452, at page 454, to "the *business* of public amusement or entertainment, from which it derived from the *public generally,* and not merely from its members, *large revenues.*" (Emphasis supplied.)

Respondent also looks to *Spokane Motorcycle Club* v. *United States,* 222 F. Supp. 151 (E.D. Wash. 1963) for support, but it is significant that in such case the District Court found at page 152 that most of the gross income was "from sales of tickets, goods and services for hill climbing events and paid by the general public", and at page 153 of its Opinion the Court referred to these sales as a *"business enterprise".* Respondent points to *Spokane Commercial Travelers* v. *Squire,* 126 F. Supp. 424 (W.D. Wash. 1954), but the revocation of the club's exemption is easily explained by the fact that the club maintained a fund for the payment of death benefits to beneficiaries named by its members, so it clearly violated the proscription of the exemption statute against inurement of earnings to the benefit of members.

Respondent is mistaken in looking to *United States* v. *Fort Worth Club of Fort Worth, Texas,* 345 F. 2d 52 (5th Cir. 1965) for rejection of the theory that an

exempt club can maintain its exemption despite the receipt of substantial amounts of passive income. In its subsequent decision on a petition for rehearing in that case, the Court of Appeals succinctly summarized at 348 F. 2d 891, 892, the crux of its prior holding: "We *held only* that the Fort Worth Club, because of substantial and recurrent outside *business* income, is not entitled to exemption from income tax as a social club * * *." (Emphasis supplied.) It is significant in this connection that respondent leaves unchallenged petitioner's contention that the criterion thus adopted by the courts below in the instant case conflicts with *Anderson Country Club, Inc.* v. *Commissioner, supra,* acquiesced in by respondent, 1944 C.B. 2, and the decisions of the United States Court of Appeals for the Fifth Circuit in *Koon Kreek Klub* v. *Thomas, supra,* and *Scofield* v. *Corpus Christi Golf & Country Club, supra.* All three cases involved the receipt of substantial amounts of outside income, and the first and third of these cases involved recurring and continuing income over a considerable period of time.

Thus, it would appear clear that there is no prior authority for the criterion used to revoke petitioner's exemption, and that the instant case is the first one in which a court has held that a social club not engaged in business loses its exemption merely because it realizes too much income from the disposition of its surplus property, consisting of mineral rights which were acquired merely as an incident to the ownership of land and which were of no use to the club.

(2) In the second part of his Memorandum In Opposition, respondent attempts to rebut petitioner's contention that the decision of the Fifth Circuit below conflicts both with its earlier decisions and with re-

spondent's interpretation of existing law in his sponsorship of H.R. 15942 and H.R. 15943 in the Second Session of the 89th Congress. The United States Court of Appeals for the Fifth Circuit took particular pains in its Opinion in the *Fort Worth Club* case, *supra*, at page 57, to distinguish the *Koon Kreek* case on the ground that such club "did not engage in those activities as a business", and to distinguish the *Corpus Christi* decision on the ground that "the royalties the club received were 'merely an incident to the ownership of the land', and that the club was neither 'actively engaged in operating non-club activities', nor did it derive income 'from the public generally' ". In the light of such concerted efforts by the Court of Appeals to distinguish the *Koon Kreek* and *Corpus Christi* cases from the commercial lease operations of the *Fort Worth Club* then before it, it would have been surprising indeed if, in subsequently denying a petition for rehearing in the *Fort Worth* case, the Fifth Circuit intended, as respondent now suggests, to treat its decision as modifying the earlier ones, and petitioner can find nothing in the text of the Opinion on the petition for rehearing, 348 F. 2d 891, 892-893, to indicate that such was the case.

Respondent also contends that Congressional consideration of H.R. 15942 and H.R. 15943, and the Treasury's sponsorship of such bills through the Assistant Secretary of the Treasury, are irrelevant to the instant case because such bills relate to the imposition of "a tax on unrelated debt-financed income of tax exempt organizations" designed to expand the "unrelated business income" provisions which "never have applied to clubs". This argument completely misses the point that the proposed bills *would tax social clubs,*

as well as all other exempt organizations, on their "unrelated debt financed income" but *would leave unaffected "income produced by investments of an organization's own funds"*. This is clearly indicated, not only by the bills, but also by Assistant Secretary Surrey's testimony which discloses that the Treasury Department's sponsorship of the bills was based upon a broad and comprehensive survey and analysis of existing law.

CONCLUSION

The conflicting views set forth in the briefs filed in the instant proceeding only serve to emphasize the urgent need for the Supreme Court to answer the troublesome questions, on which the exemption statute is silent, as to the nature and amount of outside income a social club may receive without the extremely harsh and irrevocable loss of its exemption.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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